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January 29, 2004

Hearing Clerk
U.S. Department of Agriculture
Room 1081-S
Washington, DC 20250-9200

RE: Proposed Hop Marketing Order findings and conclusions based on evidence provided at the Public Hearing held in Portland Oregon and Yakima Washington on October 15-24.

Dear Sir or Madame:

A public hearing on a proposed Marketing Agreement and Order for Hops Grown in Washington, Oregon, Idaho and California was held in Portland, Oregon, on October 15-17, 2003, and reconvened in Yakima, Washington, on October 20-24, 2003. The eight days of testimony provided ample opportunity for interested parties to offer their views concerning the need for a hop marketing order and the likely impact that the proposed order could have on the hop industry. However, a careful review of the hearing testimony leads to the inescapable conclusion that proponent testimony was vague and partial in its selective presentation of evidence meant to support its case, while ignoring facts that establish the ineffectiveness and inequities of its proposal and the previous, failed marketing order.

After more than 65 hours of testimony, critical elements of the proposed marketing order remain undefined, including important marketing order definitions and the mechanics of base allocation and saleable quantities. As a result, voting on the proposal could be haphazard and chaotic, with misfortunate results for producers unable to predict or understand the full implications of the marketing order provisions. Furthermore, the weight of the testimony did not support the proponents' assertion that the hop industry is in need of this marketing order or that the industry could benefit as a result of these new regulations. These issues are discussed in more detail below.

Key marketing order definitions remain unclear. Significant time at the hearing was spent describing the terms and conditions of the proposed marketing order. Throughout the hearing, it was clear that the proposed marketing order language was (and perhaps still is) very much a "work in progress" and that the proponents were unprepared to defend and explain the implications of specific marketing order provisions. Primary concerns include:

The definition of "handle." This was changed numerous times throughout the hearing, including a final revision on the morning of the last day's testimony (the final change being made so late that it could not be provided in writing at the start of the day's proceedings). The frequent changes were in response to continuous concerns raised about the consequences of producers unsuspectingly being defined as handlers as a result of their normal business activities, and therefore subject to the regulations and reporting requirements associated with that categorization. The increased regulatory and record-keeping requirements for handlers could be a severe burden on many producers, especially if they unknowingly become handlers as a result of vague and confusing marketing order language. But more important, the definitional issues debated throughout the hearing point to widespread misunderstanding of the ramifications of the proposed language, which complicates the ability for producers to vote on a proposal that could lead to unexpected regulation of some producers.

The definition of producer. This also remains unclear and in dispute. Although some progress was made toward the end of the hearing to compile a list of eligible producers, agreement is far from unanimous and the nature of various business arrangements, the relevancy of "producer numbers", and the implications for new growers or growers that temporarily halted production remain ambiguous. The inability for even this small industry to agree on the number of independent growing entities points to significant risk of inaccurate, inequitable, or even fraudulent allocation of voting rights and/or allotment base.

Important legal implications were not fully addressed. As noted throughout the testimony, many hop growers produce the majority of their hops under long-term contractual arrangements with brewers and/or handlers. Imposing severe marketing restrictions on these growers could force many to renege on these contracts if their saleable quantity is set below their current delivery obligations. Although raised repeatedly by the marketing order opponents, the issue was barely addressed by the proponents. This could have severe negative consequences not only on the affected producers but also on brewers and handlers that entered the contracts in support of long-term business plans. It is unclear whether producers could be held legally responsible to fulfill current obligations in the event their assigned base allotment and saleable quantity fall below contracted production. And regardless of legal liability, producers attempting to fulfill previous obligations could be faced with a substantial increase in costs if they must acquire additional base to maintain production at levels previously agreed to in good faith. Finally, the negative implications for current and future supply contracts can erode favorable business relationships between producers and buyers, and add considerable uncertainty to buyers' willingness and growers' future ability to enter supply contracts. Hence, supply controls could have the very negative unintended consequence of discouraging future long-term supply contracts.

The proposed marketing order was not justified by economic testimony. The proponent's key witness selected to testify in regard to the economic justification of the marketing order (Dr. Raymond Folwell) focused heavily on the elasticity of demand for US hops. His intent was to establish that the price elasticity of demand for US hops is inelastic (below unity), which would imply that reducing US supplies would raise grower prices an amount sufficient to increase total industry revenues. Several important points regarding this testimony should be noted:

Dr. Folwell spent considerable effort disputing the results of an analysis that was conducted by Sparks Companies, Inc. at the request of USDA[1], which found evidence that the demand for US hops could be elastic or unitary.[2] After conducting his own analysis of the data and applying a different functional form to the model, Dr. Folwell concluded that US hops could be price inelastic. However, cross-examination revealed that *Dr. Folwell's own analysis suggests a high probably that his elasticity estimate could be unitary or elastic, similar to that found in the Sparks analysis* (day 4 testimony, page 869).

Additional evidence provided by Dr. Folwell to suggest that the elasticity of demand for hops is inelastic came primarily from the unpublished 1984 Ph.D dissertation by Habuki (see hearing exhibit 26). Although Dr. Folwell cites the Habuki dissertation as the "classic study" of the US hop industry, it suffers from several deficiencies that add uncertainty with regard to the accuracy and relevancy of its results. As an unpublished document, the analysis and interpretation of results were not subject to the rigorous peer-review process that typically is required before scientific results become fully established and accepted by the discipline. It is rare for unpublished analyses to be cited as definitive scientific evidence, let alone to be regarded as "classic" analyses. In addition, the Habuki dissertation was completed in 1984, implying that the latest data used in the analysis is at a minimum more than 20 years old. All industry participants agree that the hop industry and market have evolved tremendously in the last 20 years, including the introduction of new varieties, improved hop storage techniques, and increased competition and supplies from foreign sources. These market changes generally would be expected to increase the elasticity of demand and supply, and render the Habuki analysis at best incomplete, and perhaps irrelevant to today's market.

An inelastic price response for US hops does not itself provide an economic justification for a hop marketing order. Although inelasticity is a *necessary* condition for supply controls to support industry revenues[3], it is not a *sufficient* condition to enact a marketing order. Additional consideration must be given to the accuracy with which a hop marketing order committee can monitor and predict market needs, the equity of base

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[1] The analysis was provided to USDA in a letter from Mark Jekanowski of Sparks Companies, Inc. to Charles W. Parrot, Associate Deputy Administrator of USDA/AMS, following a January 9 meeting between several hop marketing order opponents and USDA.

[2] If the price elasticity of demand for hops is not inelastic, supply restrictions applied to the US market would reduce total industry revenues below current levels.

[3] The inability for the proponents to establish with a reasonable degree of certainty that the current US hop industry is characterized by an inelastic price response raises fundamental concerns that supply controls could harm the industry by reducing total revenues.

allocation and distribution of industry revenues, and the long-term effect on technological investment and international competitiveness of the US hop industry. These economic issues are of critical importance to the hop industry and were repeatedly raised by the marketing order opponents, but were not seriously addressed in the economic analyses provided by the proponents.

<u>The methodology to be used to effectively determine market needs necessary to "balance supply and demand" was not discussed.</u> Indeed, there is no evidence that it exists. Any hope that the proposed marketing order could succeed as designed is necessarily predicated on the capacity of the eight-member Hop Administrative Committee (the "Committee") to forecast market needs in order to "balance supply and demand." Proponent testimony repeatedly suggested that a Committee would be better positioned to interpret market signals than producers acting independently, but the mechanics of the market analysis that would presumably be used by the Committee to set the saleable quantities was not explicitly discussed. Most proponent testimony simply invoked experience under the previous marketing order as evidence that supply controls can be effectively administered to support grower prices. However, the ability of the Committee to effectively balance supply and demand under the previous marketing order is at best inconclusive, and perhaps provides evidence to the contrary. The previous marketing order proved incapable of responding to market shortages from crop failures in Germany or elsewhere, and these events will continue to occur periodically and will create price fluctuations despite the best efforts of the Committee.

<u>Proponent testimony was inconsistent.</u> Throughout the testimony, proponents repeatedly pointed to the early years of the previous marketing order as evidence of its success, while dismissing the later years as a period when the order was no longer managed properly. The most commonly cited reason for the failure of the previous marketing order and improper management was "greed", but no suggestions were offered as to how this basic human frailty will be managed under the proposed new marketing order. Indeed, it cannot be. There is no reason to expect that a new marketing order will be better managed than the last, or that the situation will not again arise when the actions of the committee are so at odds with the desires of individual producers that greed will again undermine the best of intentions and bring about chaos to the domestic hop industry and another costly attempt to amend, revise, or terminate the marketing order.

The previous marketing order was withdrawn at great expense to growers and the US government. The industry spent enormous resources of time and money debating the merits of the failed marketing order and challenging (and defending) the marketing order in the court system and through USDA administrative procedures. The US government similarly spent tremendous time and resources leading up to its ultimate decision to terminate the previous marketing order. *In proposing a new marketing order, the burden of proof should rest on the proponents to show that their new proposal will be effective under various circumstances and through time. Only this can eliminate the wasteful use of resources required to once again terminate the order at a later date.* At the very least, the proponents should make every effort to demonstrate that the problems with the previous marketing order (that ultimately resulted in its demise) have been addressed under the current proposal. A review of the testimony clearly shows that the proponents failed to achieve this important, basic objective.

Allotment base will be costly and will raise costs of production. Despite proponent efforts to suggest otherwise, economic theory and past experience is unequivocal regarding the valuation of allotment base in a restricted market. Any efforts to restrict supply will be met with an increase in the value of allotment base. Some proponents suggested in their testimony that "sufficient base will be made available" such that the price will be negligible or zero. This is simply not possible. The only way for base to hold no value is if it is available in unlimited quantities; but this would imply no supply restrictions, which contradicts the purpose of the marketing order and renders it useless and ineffective. The greater the restriction on supply for any producers, the higher will be the value of allotment base. All producers wishing to enter the industry or expand, or whose saleable quantity has been set too low to fulfill outstanding contractual obligations, will be faced with the burdensome cost of acquiring necessary allotment base, which will be reflected directly in a higher total cost of production.

International competitiveness will be sacrificed. It is impossible to fully isolate the US hop industry from international market forces. Hearing testimony repeatedly emphasized that the market for hops is global: just as the oft-cited German crop failures can result in US price spikes, increased production in Germany, China, and elsewhere can and does depress world prices. Enacting US supply restrictions of any sort will send clear signals to foreign producers to increase their own production. Similarly, many US buyers can easily turn to foreign sources to fulfill needs unmet by restricted US supplies. The result will be a decreased US share of the world market, reduced US competitiveness, and only a modest if any increase in the price of domestic hops. Many marketing order proponents expressed a willingness to concede US market share for the luxury of central planning, but the reality is that this scenario would only accelerate the demise of the domestic hop industry and drive producers out of business over the long term.

The inequity of base allocation procedures remains a serious concern. The proposed marketing order continues to imply that base will be allocated according to each producer's *highest alpha production from 1997 to 2002.* The opponents continually noted in testimony and cross-examination that this allocation procedure would provide an inequitable windfall to growers that decreased production over time, at the direct expense of producers that remained stable or expanded production. This result is clearly documented (see hearing exhibits 30 and 32) and is not in dispute. The marketing order proponents appear willing to accept this implication as a necessary outcome of the proposed regulations. However, this highlights the unequal treatment of different producers that is central to the proposed marketing order, and the arbitrary nature by which this marketing order could create severe economic hardship among some, while directly rewarding others. We continue to believe this is fundamentally unfair and is not the proper or intended role of government regulation.

Similarly, the marketing order should not be a tool to compensate growers for poor business decisions made in the past. The market alone provides the necessary mechanism to set prices and determine industry needs. Growers who speculate in the market and incur losses must be held accountable for their own business decisions. And while all growers share the painful consequences of oversupply by even a few producers, over time market signals are clear and growers adept at reading those signals will benefit from the freedom afforded to them in managing their own business activities and production decisions. This is the fundamental nature of the capitalist system and should remain the guiding force of the hop industry.

High-handed market intervention cannot succeed when an industry is closely divided over the need for regulation. Hearing testimony demonstrated strong opposition to the proposed marketing order among producers of all sizes, types, and geographic location. Indeed, opposition is unanimous in Idaho, and is strong throughout Oregon and much of Washington. Producers of aroma hops voiced opposition, as did those who produce alpha and/or super-high alpha hops. Unequivocal aversion to the marketing order by many is not surprising given its authoritarian nature, the massive changes it promises for the marketing system, the severe restrictions on individual business decisions, and the clear winners and losers that would result. A cartel such as this works best if the industry is unified and support is widespread, but it could be entirely ineffective in the face of strong opposition by even a minority of producers. Implementation would undoubtedly generate widespread resentment and disappointment, while efforts to administer supply provisions consistent with "market needs" would be marked by disagreement, mistrust, and industry infighting. History and human nature suggest that legal challenges will be filed, new hearings will be requested, and the debate is unlikely to quietly subside. This divisiveness and conflict is inefficient to the industry and costly to the government, and will confound the best of intentions to smoothly implement and operate the proposed marketing order.

In summary, we continue to believe that a hop marketing order will be harmful to the US hop industry, will create inequitable transfers of wealth between growers, and will erode the ability of our industry to compete in today's global markets. The market today is far different than it was under the previous failed marketing order, and current conditions suggest that the invasive regulation and central planning activities proposed would be even less successful than in the previous setting. The advent of super high-alpha hops, the increased ability to store hops, and the declining US share in world markets suggest a market fundamentally different than two-decades ago, and these many changes will make supply controls more difficult to administer and less likely to succeed. While all growers are united in our desire to receive higher and more stable prices for hops, it is our conviction that the market remains the best mechanism to guide producer decisions.

Sincerely,

Golden Gate Hop Ranches, Inc.

Paul B Signorotti (Dn)

Paul B. Signorotti